State of Rhode Island and Providence Plantations
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Donald L. Carcieri
Governor

November 18, 2005

Ms. Magalie Roman Salas, Secretary
Federal Energy Regulatory Commission
888 First Street, N.E.
Washington, DC 20426

Re: Electric Energy Market Competition Task Force
Docket No. AD05-17-000

Dear Secretary Salas:

I am writing in response to the "Notice Requesting Comments On Wholesale And Retail Electricity Competition" ("Notice") issued on October 13, 2005 by the Federal Energy Regulatory Commission ("Commission") and the Electric Energy Market Competition Interagency Task Force (the "Task Force") created by the Energy Policy Act of 2005 (the "Act"). Section 1815 of the Act requires the Commission and the Task Force to conduct a study of competition in the domestic wholesale and retail markets for electric energy and prepare and deliver a report on their findings to Congress in August 2006.

I am submitting this comment letter to highlight what I believe are serious problems in the electric energy markets in New England that unnecessarily increase the price of electric energy to consumers, particularly in the event of dislocations in the market prices of natural gas and oil (such as those caused by the recent storm season) regardless of whether such electric energy is actually produced by natural gas or oil.

In particular, I believe severe problems are caused or exacerbated by two factors.

First, the market clearing price rule of the Independent System Operator, ISO – New England, creates an artificially high market price based on the most expensive supplier to the system. The market clearing price rule is, in my view, a failed economic concept. The argument for its adoption was that such a rule was necessary to stimulate new facility development. In reality, few new facilities have been constructed since electric industry restructuring, and those that have cannot compete in the market. Proposed initiatives of ISO-New England in its 2006 Wholesale Markets Plan to stimulate additional plant construction by "creating new markets" for LICAP and ancillary services will only worsen the situation and not remedy the fundamentally flawed underlying market. While stimulating new plant construction is a laudable objective, consumers will bear the additional costs of these initiatives at a time when industry is reaping enormous profits.

Second, the regulation of Rhode Island's legislatively created Standard Offer supply agreements, negotiated by distributors who pass costs through to consumers, does not adequately protect those consumers. Standard Offer service was intended to be a temporary means for consumers hesitant to purchase from the competitive market to continue to purchase from their local distribution companies. Provisions of the Standard Offer included rapid escalation of a base purchase price plus fuel cost escalators based on the price of oil and gas. The Standard Offer was intended to create incentives for consumers to purchase from the market and for new competitors to enter the Rhode Island market. These incentives have failed.

The effect of all these factors is to provide windfall payments to some sellers while the burden of providing such windfall payments falls squarely on already heavily burdened electric energy consumers.

Rhode Island Background.

Deregulation of electric utilities in Rhode Island began with the passage of the Rhode Island Utility Restructuring Act of 1996 (the "Restructuring Act"), which became effective in August of that year. The Restructuring Act required, among other provisions, that all Rhode Island distribution companies offer retail access from non-regulated power producers through a Standard Offer service.

The legislative intent of Rhode Island restructuring act was that the concept of a "Standard Offer" was never meant to be a permanent option for consumers. It was believed that competitive market prices would overcome the comfort of remaining with existing suppliers. However, because of the failure of a real market to develop, the concept and purpose of the Standard Offer has been thwarted. Also, the full cost of the fuel cost escalator in the underlying agreements (described below) has not yet been passed through to consumers. As a result, residential customers have remained on the Standard Offer.

Energy sold under the Standard Offer is purchased by the utility on behalf of customers and sold at no mark-up by the local distribution company. The purchase by the local distribution company is governed by long-term contracts with several sources, as successors to the original contract entered into with the USGen New England as part of its purchase of the former New England Electric System generation portfolio. Most of these contracts contain fuel cost adjustment provisions that are based on indices for oil and natural gas, regardless of the generation source. By statute, the Standard Offer will no longer be available to customers as of January 1, 2010.

Electricity is also purchased by some Rhode Island consumers under "last resort service". Last resort service customers are those who left the Standard Offer service in favor of the competitive market, but then returned to the local utility. Energy for last resort service is purchased through relatively short-term contracts. Combined with power purchased directly from power marketers, these customers account for approximately 1% of the customer base, but also approximately 14% of the power purchased in Rhode Island. Last resort service pricing is most reflective of the market rate. Many of Rhode Island's largest companies are among these customers.

The increase in energy produced over the last ten years from natural gas fired plants has been dramatic, growing from roughly 12% to over 30% of production. The appetite for natural gas for power production is causing drastic increases in the cost of gas. Availability of natural gas is becoming problematic, particularly in New England, since during times of extreme cold weather, the supply available to New England may be insufficient to fulfill the demand from residential heating and power production simultaneously.

The recent hurricane season has resulted in serious damage to natural gas and oil production and refining facilities. This, combined with tight international markets, has lead to record-breaking profits for many energy companies and possible price gouging elsewhere in the energy supply chain. With the upcoming winter, this confluence of falling temperatures and record high natural gas and oil prices creates a situation for Rhode Island that is both economically and personally dangerous.

Flaws in market based regulation.

At least part of the problem has been created by what I believe are flaws in the Independent System Operator's energy pricing system, which the Commission must remedy if the promise of market based rates is to be realized. These flaws, as magnified by the current disruptions in energy markets, are found in at least the following areas.

The first area is in the market clearing rules of ISO-New England which produce artificially high energy prices by requiring that all wholesale electric energy suppliers receive the highest price paid to any successful bidder. Such devices are not unique to ISO-New England and are, I believe, the subject of controversy in other proceedings.

When the highest accepted bid price under such market clearing rules is further increased by the effect of market disruptions on natural gas and oil fired generation, the result is an unjust and unreasonable windfall to bidders whose power is not produced by such generation, but is, instead, produced by nuclear power, hydroelectric facilities, coal or other alternative technologies. As New England's generation mix is made up of approximately thirty percent natural gas fired generation and approximately seventeen percent oil fired or combination oil/natural gas fired generation, such windfalls place a significantly increased burden on residential consumers and businesses, significant numbers of whom are struggling to survive.

Bid prices ideally would consist of capital, fuel, other variable costs, and profit. Only a system incorporating this concept would produce a true competitive market. That having been said, the integrity of the system must also be preserved. The lights need to go on when the switch is thrown. This means that the "must run" plants, those with large capacity, which coincidentally are not readily dispatched and have the lowest all-in costs, should not be able to game the system.

Such plants currently enjoy a monopoly on the first 8,000 to 10,000 megawatts of required capacity. I suggest that your deliberations need to recognize that fact, and consider a possible return to cost-of-service regulation for facilities in this category. Facilities capable of dispatch would remain in a competitive environment.

The second area of concern is in contractual provisions in electric energy supply agreements which may be negotiated on behalf of consumers but without necessary oversight or protections for consumers. In Rhode Island, for example, contracts which supply the Standard Offer now include fuel cost escalators that are passed through to consumers and tied to the price of natural gas and oil, without regard to whether or not such electric energy is actually supplied by facilities which consume natural gas or oil in producing the energy. While this may implicate state law as well as market concerns, I am concerned that consumer interests may fall into a gap between federal regulation, state regulation and deregulation and that these contracts may not accurately reflect true arms length negotiations since the party through whom the costs are passed (in this case the distribution company) have no financial incentive to negotiate a true market price.

Again, the current disruptions have allowed suppliers to increase their revenues under such contracts without regard to whether or not the suppliers are actually incurring greater costs to produce such energy. The problem is not the supplier that actually has to burn extraordinarily high-priced natural gas or oil to produce electric energy; it is the supplier who does not actually incur those expenses, but is paid as though it did.

Under cost based utility regulation, there would have been no such windfall to such suppliers. It is very difficult to justify the windfall profits to some suppliers under the above scenarios as necessary for just and reasonable rates, even in a market based system such as the present one. Rather, it must be the function of good regulation to step in and protect consumers when the marketplace does not do so.

Summary

It has become apparent that the "deregulated" energy market, whether wholesale or retail, is still an evolving concept and one that is not working well in many markets including New England. The Commission needs to take an ongoing proactive approach in order to refine and shape deregulation in ways that will obtain and retain for consumers the benefits that led us to embrace deregulation in the first instance. In fact, the Commission has recognized this in the past by capping rates in extraordinary circumstances where it concluded that the marketplace, on its own, was not sufficient to protect consumers.

In the case of these inequities, the Commission and the Task Force should reexamine the current market based arrangements so as to eliminate these windfall profits or, at a minimum, to greatly reduce them through reformation of contracts, bidding procedures and market price refinements such as caps, collars or such other appropriate devices as will adequately protect consumers in the deregulated marketplace. In addition, local capacity issues may be more economically addressed by improvements in transmission capacity, rather than creating more generating facilities closer to load centers. This is an issue that must be considered as part of the deliberations on LICAP.

I appreciate the opportunity to make these comments and look forward to participating in further proceedings aimed at improving the deregulated environment. If there are any questions in connection with this letter, please contact Andrew Hodgkin, my Executive Counsel, at (401) 222-8114 or at ahodgkin@gov.state.ri.us.

Thank you for your consideration.

Sincerely,

Donald L. Carcieri